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IN THE

SUPREME COURT
OF THE
UNITED STATES.

October Term, 1937

No. 388.

BANKLINE OIL COMPANY, a corporation,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

BRIEF FOR THE PETITIONER.

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BRIEF FOR THE PETITIONER.

Statement Disclosing Basis of Jurisdiction.

(a) The statutory provision sustaining the jurisdiction of this Court is conferred by Section 240-(a) of the Judicial Code, as amended by the Act of February 13, 1925.

(b) The opinion of the Board of Tax Appeals [R. 42-56] is reported in 33 B. T. A. 910.

(c) The judgment of the Circuit Court of Appeals was entered June 7, 1937 [R. 154] and is reported in 90 Fed. (2d) 899. [R. 144-154.]

(d) Petition for certiorari was filed September 7, 1937 and was granted October 25, 1937.

Question Presented.

Is the income of a lessee of State tide lands under an oil and gas lease, in which the State reserves a royalty, subject to Federal income taxes under the Revenue Act of 1928?

Statement of the Case.

This action was instituted by petitioner in the United States Board of Tax Appeals for the recovery of certain overpayments in income tax made by petitioner for the calendar yars 1927, 1928 and 1930. It involvd two entirely separate and unrelated questions.

In so far as the question involved in this petition is concerned, the suit was brought for the recovery of income taxes charged against petitioner for the year 1930 upon income derived by petitioner from an oil and gas lease from the State of California.

The facts applicable to the particular question involved in this petition are entirely without dispute. In fact, they were the subject of a stipulation entered into between counsel for petitioner and counsel for the Commissioner of Internal Revenue prior to the hearing before the Board of Tax Appeals. [R. 73, 74.]

On October 22, 1929, the State of California, pursuant to Chapter 303, Statutes of California, 1921, approved May 21, 1921, entitled "An Act to Reserve all Minerals in State Lands, etc.", leased certain oil and gas lands situated in the County of Santa Barbara, State of California, to H. J. Barneson, reserving to itself a royalty. The lease covered lands situated below the tide line, and is known as Lease No. 89, or the Elwood Lease.

The statute referred to provides in Section 4 for the issuance of prospecting permits. Section 5 of the Act provides that a permittee, upon establishing to the satisfaction of the Surveyor General that oil and gas in commercial quantities has been discovered on the permit lands, shall be entitled to a lease on the lands embraced in the permit. The section further provides that

> "such lease shall be for a term of twenty years upon a royalty of five per centum in amount or value of the production * * *."

The Act also provided that prior to the issuance of a lease the lessee

> "shall pay to the State of California twenty per centum of the gross value of all oil or gas secured by him from the lands embraced within this permit * * *."

At the time of the issuance of the lease, Barneson was a vice-president and director of petitioner and was acting on its behalf in acquiring the lease. On November 14, 1929, Barneson and his wife assigned all of their right, title and interest to the lease to Bankline Oil Company. This assignment was approved by the State of California on December 19, 1929.

On acquiring the lease, petitioner immediately commenced drilling operations. Those operations were successful and resulted in the discovery of oil which petitioner produced during all of 1930. During 1930 its net income as a result of the production from Lease No. 89 was $139,014.28.

Specification of Error.

Your petitioner respectfully submits that the Circuit Court of Appeals committed error in refusing to follow the decision of this Court in *Burnet v. Coronado Oil & Gas Co.*, 285 U. S. 393, and in determining that the income of petitioner as the lessee of oil and gas lands from the State of California was subject to taxation under the Revenue Act of 1928.

Summary of Argument.

In support of its contention petitioner presents the following propositions of law:

1. A tax upon the income of a lessee of State tide lands, under an oil and gas lease reserving a royalty to the State, is a tax upon an instrumentality of the State and is therefore improper.

2. The State of California holds its tide lands in a governmental capacity in trust for the benefit of the general public.

3. This Court in deciding *Burnet v. Jergins Trust*, 288 U. S. 508, did not, and did not intend to, overrule its decision in *Burnet v. Coronado Oil & Gas Co.*, 285 U. S. 283.

I.

A Tax Upon Appellant's Income From Lease No. 89 Is a Tax Upon an Instrumentality of the State of California and Is Unconstitutional.

(a) The United States May Not Levy an Income Tax Upon an Instrumentality of a State.

One of the primary principles, upon which the Constitution of the United States was founded, was that there should be a division of powers between the United States on the one hand and the several sovereign states on the other. In order to carry out that principle, it was established very early in our judicial history that neither a State nor the United States could tax the property, or the governmental agencies or instrumentalities of the other.

M'Culloch v. Maryland, 4 Wheat. 316;

Weston v. Charleston, 2 Pet. 449;

The Collector v. Day, 11 Wall. 113;

Northwestern Mutual Life Insurance Co. v. Wisconsin, 275 U. S. 136;

Macallen Co. v. Massachusetts, 279 U. S. 620;

Indian Motocycle Co. v. United States, 283 U. S. 570.

Thus it has been that a state cannot tax government bonds either by levying an *ad valorem* tax,

Weston v. Charleston, 2 Pet. 449;

or a gross income tax,

Northwestern Mutual Life Insurance Co. v. Wisconsin, 275 U. S. 136;

or a net income tax,

Macallen Co. v. Massachusetts, 279 U. S. 620;

Pollack v. Farmers Loan & Trust Co., 157 U. S. 429.

For like reasons the United States may not tax the salary of an officer of the state.

Buffington v. Day, 11 Wall. 113.

Nor may either the state or the Federal government levy sales or excise taxes upon persons selling commodities to the other.

Panhandle Oil Co. v. United States, 277 U. S. 218;

Indian Motocycle Co. v. United States, 293 U. S. 570;

Graves v. Texas Company, 298 U. S. 393.

The principle underlying this rule is that a tax by the United States upon one of the instrumentalities of a state is a direct burden upon and an interference with the state's exercise of its sovereign powers.

As stated by this Court in the early case of

Weston v. Charleston, 2 Pet. 449, 465, 468, 469:

"The tax in question is a tax upon the contract subsisting between the Government and the individual. It bears directly upon that contract while subsisting and in full force . . .

"The right to tax the contract to any extent, when made, must operate upon the power to borrow before it is exercised, and have a sensible influence on the contract. The extent of this influence depends on the will of a distinct Government. To any extent,

however inconsiderable, it is a burden on the operations of Government . . .

"The tax on Government stock is thought by this Court to be a tax on the contract, a tax on the power to borrow money on the credit of the United States and consequently to be repugnant to the Constitution."

Though the tax may be in form upon a private individual, it is still unconstitutional if it has the effect of burdening a transaction in which the state is involved.

Panhandle Oil Co. v. Mississippi, 277 U. S. 218, 222:

"It is immaterial that the seller and not the purchaser is required to report and make payment to the state. Sale and purchase constitute a transaction by which the tax is measured and on which the burden rests . . .

"The necessary operation of these enactments when so construed is directly to retard, impede, and burden the exertion by the United States, of its constitutional powers to operate the fleet and hospital."

See, also:

United States v. Baltimore & Ohio R. R. Co., 17 Wall. 322.

Another factor ignored in cases of this type is the extent of the burden. Unlike cases on interstate commerce, if the interference exists the ban is absolute, despite the fact that the burden imposed is not great.

Indian Motocycle Co. v. United States, 283 U. S. 570, 575:

"Where the principle applies it is not affected by the amount of the particular tax or the extent of the resulting interference, but is absolute."

However, the only ones who may claim the exemption are those who are acting as instrumentalities of the Government. The exemption does not extend to independent contractors who, for an agreed consideration, have undertaken to perform certain work on behalf of the Government.

Metcalf v. Mitchell, 269 U. S. 514;

Alward v. Johnson, 282 U. S. 509;

James v. Dravo Contracting Co., 82 L. Ed. Adv. Op. 125.

As has been frequently pointed out, the line of distinction is frequently hard to draw but the Court can and does draw such a line.

(b) PETITIONER, AS OPERATOR OF LEASE NO. 89 FOR THE STATE OF CALIFORNIA, IS ACTING AS AN INSTRUMENTALITY OF THE STATE.

The question of into what category the lessee of a state or of the United States falls is not a new question for this Court to decide. On several occasions it has been presented to this Court for decision. In each case the Court has held that a person who holds an oil and gas lease from a state or from the United States under an agreement whereby the governmental lessor reserves a royalty or a share of the production, the lessee is an instrumentality of the state.

Gillespie v. Oklahoma, 257 U. S. 501, 504, 506:

"The lessee was an instrumentality used by the United States in carrying out duties to the Indians that it had assumed . . .

"The same considerations that invalidate a tax upon the leases invalidate a tax upon the profits of the leases; and, stopping short of theoretical possibilities, a tax upon such profits is a direct hamper upon the effort of the United States to make the best terms that it can for its wards."

Jaybird Mining Co. v. Weir, 271 U. S. 609, 613:

"The lessee is an agency or instrumentality employed by the Government for the development and use of the restricted land and to mine ores therefrom for the benefit of its Indian wards."

Chocktaw R. R. Co. v. Harrison, 235 U. S. 292, 298:

"Appellant is the instrumentality through which this obligation is being carried into effect. Such an agency cannot be subjected to an occupation or privilege tax by a state."

See, also:

Indian Territory Illuminating Oil Co. v. Oklahoma, 240 U. S. 522,

in which the Court rejected the contention of the state that such a lessee was an independent contractor.

In

Burnet v. Coronado Oil & Gas Co., 285 U. S. 393, 400;

a case virtually identical with the instant case, this Court held that a Federal income tax upon the income of a lessee under a state oil and gas lease was an interference with the state's exercise of its sovereign powers.

The state of Oklahoma had issued an oil and gas lease to the Coronado Oil and Gas Co. The United States sought to levy an income tax upon the income derived by the Coronado Oil and Gas Co. from that lease. The Supreme Court held that that portion of the company's income that was received from the state lease was exempt from taxation, saying:

> "When Oklahoma undertook to lease her public lands for the benefit of the public schools she exercised a function strictly governmental in character
>
> . . .
>
> "Here the lease to the respondent was an instrumentality of the State for the purpose of carrying out her duty in respect of public schools. To tax the income of the lessee arising therefrom would amount to an imposition upon the lease itself."

See, also:

> *Mountain Producers Oil Corp. v. Commissioner,* 92 Fed. (2d) 78 (C. C. A. 10).

In order to induce a person or a corporation to prospect lands for oil, a landowner must offer his prospective lessee an opportunity to make a reasonable profit from his operations, should they be successful. The drilling of oil wells, particularly on tide lands, is a very expensive proposition. The risk is great, for there is always the possibility that a well will be dry, in which event the entire investment is lost. Consequently, no person would undertake such a venture unless he was assured that, if his efforts were crowned with success, he would make a sufficient profit to

compensate him for the risk involved. One of the important elements considered by a prospective lessee who is trying to estimate his possible return on a particular lease, is the amount of royalties he will have to pay to his landowner.

The exemption from taxation of the profits derived from oil operations on state lands has a direct bearing upon the amount of royalties which the state, as landowner, can exact from its lessees. If the income of the state's lessee is exempt from Federal income taxes, the state would be in a position to charge its lessees a higher royalty than it could otherwise collect. Economically the lessee could afford to increase the royalty paid to the state by the amount which he would otherwise be required to pay as income taxes. To put it in another way, if the state's lessee were required to pay income taxes to the United States, his ultimate margin of profit, out of which his royalties would be paid, would be reduced. The amount of royalties he could afford to pay would be similarly reduced, and the state would suffer to that extent.

We submit that the tax in question is a direct interference with the means used by the state to develop its natural resources.

Petitioner is in very much the same position as a holder of municipal bonds. The purchaser of bonds lends money to his state and in return receives a profit on his investment in the form of interest. Petitioner, as a lessee of State tide lands, advanced money for the purpose of drilling oil wells for the State. When the venture was successful petitioner made a profit.

In both cases an income tax upon those profits is unconstitutional. Just as a tax upon the income from state bonds

> "would operate on the power to borrow before it is exercised, and would have a sensible influence on the contract."
>
> *Pollack v. Farmers Loan & Trust Co.*, 157 U. S. 429, 586;

so a tax upon the income of the lessee of the State would operate on the power of the State to make a lease before it is exercised.

We submit that the income tax which the United States seeks to impose upon petitioner is a direct interference with the means used by the State to develop its natural resources.

In addition to constituting such an interference with the functioning of the State, the tax is in effect a tax upon real property owned by the State of California. It has long been recognized that a tax upon the rents and profits of realty is, in effect, a tax upon the land.

> *Pollack v. Farmers Loan & Trust Co.*, 157 U. S. 429.

We believe that it is apparent from the foregoing that the tax here in question is a tax upon real property owned by the State of California and upon the lease from the State to petitioner. That lease being an instrumentality of the State, the tax imposes a burden upon that instrumentality and is, therefore, an unconstitutional levy.

> *Burnet v. Coronado Oil & Gas Co.*, 285 U. S. 393.

II.

The State of California Holds Its Tidelands in Trust for the Benefit of the People.

When the original thirteen states joined together to form the Union, title to tidelands was reserved to them. Similarly, when California was admitted to the Union title to the tide lands bordering on its shores passed from the United States, which had held them since they were acquired from Mexico, to the state.

Borax Consolidated v. City of Los Angeles, 296 U. S. 10.

Those lands are held by the State in trust for the benefit of the people.

Illinois Central Railroad Co. v. Illinois, 146 U. S. 387.

This Court, in referring to the lands under the navigable water of Lake Michigan, said:

> "But it is a title different in character from that which the state holds in lands intended for sale. It is different from the title which the United States holds in the public lands which are open to pre-emption and sale. It is a title held in trust for the people of the state." (p. 452.)

And a little later, on page 453, referring to the disposal of these lands, they continued:

> "Such abdication is not consistent with the exercise of that trust which requires the government of the state to preserve such waters for the use of the public.

The trust devolving upon the state for the public, and which can only be discharged by the management and control of property in which the public has an interest, cannot be relinquished by a transfer of the property. *The control of the state for the purposes of the trust can never be lost.* . . ." (Italics ours.)

Heckman v. Sweet, 99 Cal. 303:

"Navigable streams and the shores to ordinary highwater mark are held by the state in trust for the public;"

Ward v. Mulford, 32 Cal. 365, 372:

"The land which the state holds by virtue of her sovereignty, as is well understood, is such as is covered and uncovered by the flow and ebb of the neap of ordinary tides. Such land is held by the state in trust and for the benefit of the people."

See, also:

Oakland v. E. K. Wood Lumber Co., 211 Cal. 16, 23;

Boone v. Kingsbury, 206 Cal. 148;

People v. Goldrun Mining Co., 66 Cal. 138, 151.

Inasmuch as the foregoing rule is a rule of property in California, the Federal Courts will follow the rule as adopted by the Courts of California.

United States v. Mission Rock Co., 189 U. S. 391.

While the state may dispose of its property to private individuals, it can only do so when the use to which the individual proposes to put the property is for the benefit of, and not inconsistent with, the public trust on which the property is held by the state.

Weber v. State Harbor Commissioners, 18 Wall. 57;

Boone v. Kingsbury, 206 Cal. 148;

Forestier v. Johnson, 164 Cal. 24;

Heckman v. Swett, 99 Cal. 303;

Taylor v. Underhill, 40 Cal. 471.

In

Boone v. Kingsbury, 206 Cal. 148, 181, 182, 184,

the California Supreme Court had under consideration the constitutionality of the very act under which Lease No. 89 was issued by the State to petitioner. That Court held that the State had power to issue leases to State tide lands and that the granting of such leases did not affect in any way the title of the State and did not alter the trust capacity in which the State held the property.

"It is clear that one of the purposes of the Legislature by the enactment of said chapter 303, Statutes and Amendments of 1921, page 404, was to give to the citizens an opportunity to intercept the large volumes of oil gravitating seaward to inextricable depths, and to reduce to useful purposes oil, gas and mineral deposits reposing beneath the ocean's bed. . . .

"The license or privilege authorizing the permittee to prospect and mine tide-lands is denominated by the act a lease, but in practical effect it strongly partakes of the character of a contract to prospect or mine

said tide-lands on a share or percentage basis. In no sense does the state part with title to its tide-lands. . . .

"The license or privilege or leasehold by which the permittees are granted the right to explore and mine for gas and oil does not constitute a grant or sale of tide-lands in the sense that those terms are used in the prohibitory provisions of article XV, section 3, State Constitution."

If any confirmation of the fact that the State, while granting the leases to tidelands, still held those lands in its sovereign capacity in trust for the benefit of the public, that confirmation appears from the act itself.

Section 19 of the State Leasing Act provides that all monies received as a result of the leasing of tide lands "shall be deposited in the 'general fund'." (1921 Stat., Chap. 303.)

We submit that no valid distinction can be drawn between the status of the Oklahoma leases and the California leases. Can it be said that a state which uses revenues from oil leases for school purposes holds the property in trust, while one which holds property in trust for the benefit of the public and turns the revenues derived from the leasing of the same into its general fund does not? The similarity is even more aparent in the case of California, where the monies for public schools are a first lien on the general fund."

Constitution, Article XIII, Section 15:

"Out of the revenue from State taxes for which provision is made in this article, together with all other State revenues, there shall first be set apart the moneys to be applied by the State to the support of the public school system and the State university."

III.

The Authorities Cited by the Circuit Court of Appeals Do Not Support Its Decision.

The Circuit Court of Appeals, in rendering its decision, relied primarily upon

Burnet v. Jergins Trust, 288 U. S. 508, 516.

In that case the City of Long Beach, California, had given to Jergins an oil and gas lease on property which the city had purchased for use in connection with its water system, but was not being so used. The lessee sought to establish that the income he received from the lease was immune from taxation under the Federal Revenue Acts.

The Court denied him the immunity claimed and distinguished *Gillespie v. Oklahoma, supra*, and *Burnet v. Coronado, supra*, saying:

> "The respondent relies upon *Gillespie v. Oklahoma*, 257 U. S. 501, 66 L. Ed. 338, 42 S. Ct. 171, and *Burnet v. Coronado Oil & Gas Co.*, 285 U. S. 393, 76 L. Ed. 815, 52 S. Ct. 443, as authorities binding upon us and requiring a decision in its favor. *In both of those cases the sovereign was acting as the trustee of an express trust with regard to the lands leased.* In both the burden upon the public use was more definite and direct than in the present case. As said in the Coronado Oil & Gas Co. case, the doctrine of Gillespie v. Oklahoma is to be applied strictly and only in circumstances closely analogous to those which it disclosed. The decisions relied on cannot be held to be authority upon the facts presented by this record." (Italics ours.)

No such distinction may be drawn in the instant case. As we have already pointed out, the State of California holds its tide lands in trust for the benefit of the public. Such a trust can not stand in a different category than the trust that existed in *Gillespie v. Oklahoma, supra,* and in *Burnet v. Coronado, supra.* The petitioner here is entitled to the same exemption as the lessees in the cases cited, for the burden upon the public use is just as definite and direct. We, submit, therefore, that the decision in the instant case cannot be controlled by *Burnet v. Jergins Trust, supra,* for the reason the element of public trust, lacking there, is found in the case at bar.

The Circuit Court also referred to

Group No. 1 Oil Corporation v. Bass, 283 U. S. 279,

as an authority for its decision. We submit that that decision cannot be considered as a precedent in the instant case. Under Texas law an oil and gas lease is considered as a sale of the oil in place, while in California and Oklahoma a lessee acquires only a profit *a prendre,* or right to remove the oil.

The distinction was recognized by this Court in

Burnet v. Coronado, supra,

where the Court said, at page 399, after referring to the *Bass* case:

> "As there distinctly indicated, the exemption claimed by the Oil Corporation was denied because under the settled rule applied by the Texas Supreme Court the oil and gas from disposal of which the corporate income arose had been purchased, not obtained under

lease—title had passed out of the State by a present sale. Status of the title was matter for determination under the laws of the State as construed and applied by her courts. In the present cause there is no basis for saying that according to the local law, the transaction between the State and the lessee amounted to a sale."

Similarly there is no basis for saying that the lease from the State of California to Bankline Oil Company amounted to a sale of the oil in place.

Boone v. Kingsbury, 206 Cal. 148, 184.

"The license or privilege or leasehold by which the permittees are granted the right to explore and mine for gas and oil does not constitute a grant or sale of tide lands."

Callahan v. Martin, 3 Cal. (2d) 110, 118.

"We are of the view that an operating lessee under a lease for a term of years, or for a term of years and so long as oil shall be produced in paying quantities, has an interest or estate in real property in the nature of a profit *a prendre,* which is an incorporeal hereditament."

See, also:

Bandini Petroleum Co. v. Superior Court, 110 Cal. App. 123, Aff'd. 284 U. S. 8;

Dabney v. Edwards, 5 Cal. (2d) 1;

Dabney-Johnston Oil Corp. v. Walden, 4 Cal. (2d) 637;

People v. Associated Oil Co., 211 Cal. 93.

Conclusion.

In conclusion we submit again that the present case may not be distinguished from *Burnet v. Coronado Oil & Gas Co., supra,* or from *Gillespie v. Oklahoma, supra.* In all three cases the state held the leased lands as a trustee for a public purpose. Those purposes were substantially similar.

To exempt the income of a lessee of the State of Oklahoma from Federal income tax and, at the same time, to levy a tax upon the income of a lessee of the State of California, would be a travesty on justice.

We therefore submit that the $139,014.28 derived by petitioner from its operations as a lessee of the State of California on Lease No. 89 is not subject to taxation under the Federal Revenue Laws, and that petitioner is entitled to a refund of $16,681.71.

Dated, Los Angeles, California, January 22, 1938.

Respectfully submitted,

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Of Counsel.